China’s Economic Growth and Regional Decentralization

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China’s Economic Growth

• Spectacular Chinese economic growth performance since the reforms started in 1978
  – Growth: prolonged high growth at an unprecedented scale
  – Poverty reduction: largest scale in human history
  – Largest foreign reserve and one of the largest FDI recipients
  – R&D: the 5th largest patent applicant country in the world (OECD report, 2007)
  – Huge and fast growing impacts to the global economy

• What are the most important institutional changes which drive Chinese economic growth?

• Chinese regional decentralization as an explanation

• Will Chinese growth sustainable?
  – Is Chinese regional decentralization a proper institution for China’s further development and growth?
Fundamental Chinese institution: Regionally decentralized authoritarianism

- China is highly centralized in personal controls and mass media controls
  - Provincial level officials are directly controlled by the central government
  - Nested personnel controls over lower level regional officials
- Highly decentralized in resource allocation & business activities
- Regional governments run the economy
  - Most SOEs are under regional government control
  - Almost all firms in non state sector are under regional government control (regulation and resource allocation)
- Regions (provinces, cities, counties) are relatively self-contained
  - Provide conditions for regional competition and regional experiments
- The degree of decentralization varies over different periods but the fundamental institution has been stable
  - Decentralization-centralization cycles
Brief Historical Overview of the Fundamental Chinese Institutions

- Mao, On the Ten Major Relationships, 1956
  - Setting up basic principles of regional decentralization
- The first wave of regional decentralization: the People’s Commune Movement and the Great Leap Forward Movement, the late 1950s
  - Large scale transfer of power/resources to regional governments
  - Setting up self-contained communes nationwide
  - Coordination disaster and great famine
- The second wave of regional decentralization: “the Cultural Revolution,” 1966-1976
- When reforms started in 1978 the regional decentralization is already in the place
- All variations since then have never changed the basic structure
Fiscal Decentralization Is Only One Aspect of Regional Decentralization

- Regional governments control major resources within their jurisdictions
  - Most SOEs and COEs are owned by regional governments
  - Land is de facto owned by regional governments
  - Regional governments’ influences on allocation of energy and financial resources

- Regional fiscal policy is only part of regional governments’ activities
  - It is a good proxy for regional decentralization for certain periods, e.g. 78-93

- Have to be careful when measuring regional decentralization by fiscal policy alone
  - Fiscal revenue/expenditure may not reflect autonomous power delegated to regional governments
  - 1994 fiscal recentralization was associated with an enlargement of regional governments’ power in some areas
    - Green lights for various privatization measures in firms and in land
## Chinese Central & Sub-national Fiscal Revenue

Unit: 100 million RMB

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Central</th>
<th>Provincial</th>
<th>Provincial/Total</th>
<th>Institutional Changes</th>
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</thead>
<tbody>
<tr>
<td>1953</td>
<td>213.24</td>
<td>177.02</td>
<td>36.22</td>
<td></td>
<td>17% 1st Five Year Plan</td>
</tr>
<tr>
<td>1958</td>
<td>379.62</td>
<td>305.26</td>
<td>74.36</td>
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<td>20% 2nd Five Year Plan</td>
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<tr>
<td>1959</td>
<td>487.12</td>
<td>118.78</td>
<td>368.34</td>
<td></td>
<td>76% Great Leap Forward</td>
</tr>
<tr>
<td>1961</td>
<td>356.06</td>
<td>76.65</td>
<td>279.41</td>
<td></td>
<td>78%</td>
</tr>
<tr>
<td>1966</td>
<td>558.71</td>
<td>196.49</td>
<td>362.22</td>
<td></td>
<td>65% Cultural Revolution</td>
</tr>
<tr>
<td>1975</td>
<td>815.61</td>
<td>96.63</td>
<td>718.98</td>
<td></td>
<td>88%</td>
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<tr>
<td>1978</td>
<td>1132.26</td>
<td>175.77</td>
<td>956.49</td>
<td></td>
<td>84% Reform Starts</td>
</tr>
<tr>
<td>1980</td>
<td>1159.93</td>
<td>284.45</td>
<td>875.48</td>
<td></td>
<td>75% Fiscal reform starts</td>
</tr>
<tr>
<td>1984</td>
<td>1642.86</td>
<td>665.47</td>
<td>977.39</td>
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<td>59%</td>
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<tr>
<td>1988</td>
<td>2357.24</td>
<td>774.76</td>
<td>1582.48</td>
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<td>67%</td>
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<td>1993</td>
<td>4348.95</td>
<td>957.51</td>
<td>3391.44</td>
<td></td>
<td>78% Fiscal decentralization ends</td>
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<tr>
<td>1994</td>
<td>5218.1</td>
<td>2906.5</td>
<td>2311.6</td>
<td></td>
<td>44% Fiscal rule change</td>
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<tr>
<td>2004</td>
<td>26396.47</td>
<td>14503.1</td>
<td>11893.37</td>
<td></td>
<td>45%</td>
</tr>
<tr>
<td>2005</td>
<td>31649.29</td>
<td>16548.53</td>
<td>15100.76</td>
<td></td>
<td>48%</td>
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</table>
Regional decentralization and Successful earlier reforms

• Most earlier successful reforms involved regional competitions and were based on regional experiments

• A basic reform strategy is to let regions at all levels compete to each other

• Regional experiments initiated by regional governments
  – Household responsibility system initiated by Fengyang and promoted to regions nationwide

• Regional experiments initiated by the central government and promoted nationwide later
  – Special economic zones started from Shenzhen etc. and promoted to regions nationwide
Evidence: Growth and Regional Decentralization
(Lin and Liu, 2000; with panel data of 1970-93)

• Reforms based on regional decentralization explains most of regional growth
  – Non state sector development had the greatest impact on regional growth
    • The share of non-SOEs' output in the total industrial output (NSOESH)
    – Household responsibility system (HRS) had the second greatest impact on regional growth
• Fiscal decentralization (FD) also affected growth but with substantially smaller magnitude

\[ g_{it} = 0.26NSOESH_{it} + 0.057HRS_{it} + 0.026FD_{it} + 0.054GI_{it} \]

(3.81) (2.30) (1.66) (2.88)  \[ R = 0.56 \]
Conditions for decentralization be successful

• Regional decentralization itself is not sufficient for reform/growth to occur
  – Although it provides mechanisms for regional competition and regional experimentation

• Chinese regional decentralization has been in the place for long but reform and fast growth only occur after 1978

• Decentralization in many countries did not work

• Other conditions to make regional decentralization work
  – Central government’s objective
    • Incentives given to regional governments
  – Ranges of control delegated to regional governments
Conditions that make Chinese regional decentralization successful

• National government is sufficiently strong
  – To keep political stability
    • Political stability can be an equilibrium when there are strong collective incentives among the elites for political stability at the end of the Cultural Revolution
  – To keep national unity
    • Long history of being a unified country with ethnic homogeneity
  – To keep macro control

• Regional governments have controls over sufficient amount of resources in wide ranges
  – As a condition to make regional autonomy possible
  – This is particularly important for developing countries where markets are not well developed
Determinants of the objectives of the national government

• Improving economic performance provided legitimacy for the first generation of national leadership after the “Cultural Revolution”
  – Politics at the end of the Cultural Revolution: Deng vs. “Gang of Four”
  – An agenda shared by most officials and constituency: The popularity of “the Four Modernization” vs. declined revolutionary ideology
  – Against the Cultural Revolution legacy change is necessary
  – An agenda with political implications: replacing the agents of the “Gang of Four”

• Reform has been regarded as necessary to improve economic performance
  – Lessons from FSU and CEE stagnation and reforms – no reform no growth

• Reform and performance provide legitimacy for later generations of national leaders
  – They are consistent with and necessary for nationalism
  – Most reform agendas have to be implemented through regional governments

• Economic reforms and regional decentralization are in the interests of most national officials
Tradeoffs Posed by Chinese regional decentralization

• Two sides of the same coin
  – Spectacular performance and severe problems are both created by regional decentralization

• Regional decentralization leads to regional competition

• Consequences of regional competition
  – Drives regional growth
    • Attracting regional FDI
    • Regional urbanization
  – Drives regional protection
  – Drives land/environmental abuse
  – Distorts law enforcement; resists judiciary independence
  – Resists macro control
  – Ignores factors creating externalities (e.g. social security)

• Tradeoffs of regional decentralization determines what China does and where China goes
Tradeoffs: regional competition

• Devolution of self-contained regions creates conditions for yardstick competitions at higher levels of regional governments (Maskin, Qian and Xu, RESTu 2000)
  – Compete for setting up regional business, e.g. attracting FDI

• Race to the top?
  – Compete for growth
  – Promotion/demotion is linked to regional growth (MQX, 00; Li and Zhou, 06)

• Race to the bottom?
  – May compete for resisting macro control
  – May compete at abusing land/environment

• There is multiple equilibrium and some equilibriums are not optimal
Regional decentralization and experiments

• Self-contained autonomous regions create conditions for regional experimentations for testing reform policies (Qian, Roland and Xu, JPE 2006)
  – HRS, SEZ, fiscal decentralization (Jiangsu, 1997), privatization (gai-zhi), social safety net, etc.

• The tradeoffs associated with regional competition determines directions of experiments

• What are chosen to be experimented and what are chosen to be promoted are determined by incentives of regional governments – race to the top/bottom?
  – May experiment some suboptimal policies
  – May refuse to promote better policies which have been successfully experimented in other regions

• There is multiple equilibrium and some equilibriums are not optimal
Multi task nature of regional governments

• Control mechanism of a regional decentralized authoritarian regime
  – Regional competition within a region based multi level hierarchy
  Personnel control (appointment, promotion/demotion) is the key of the control

• Multi task nature of the regional governments
  – Regional governments are responsible for multiple objectives
  – Officials have ‘private business’ or rent seeking activities
  – There are conflicts among these multiple objectives

• Incentives of regional governments
  – With a properly designed incentive scheme regional competition can lead to a race to the top, if
    • All tasks are well measured (MQX (2000) and QRX(2006) are examples)
  – If one objective is well measured but others are not regional competition may lead to a race to the bottom for poorly measured objectives
  – Sustainable growth may depend on many objectives
Regional decentralization: past and future

• At early stages of Chinese reforms (before the early 2000s)
  – Economic growth was the most important objective
    • Commonly agreed by the central government, regional governments and the constituency
    • Sacrificing other objectives are tolerable

• At later stages of Chinese reforms (after the early 2000s)
  – Value of other objectives, e.g. inequality & environment, is raised
  – Sustainability of growth requires better solutions of these issues
  – Multi task nature becomes more pronounced

• Can the problem be solved within the regional decentralized authoritarian framework?
  – To deal with multi tasks within a hierarchy agents have to be given low powered incentives
  – It will reduce agents’ efforts greatly
    • Vigorous regional competition may not be desirable any more
  – An ultimate solution is beyond such hierarchical structure
Conclusion

- Mechanisms associated with regionally decentralized authoritarian drove the changes of the Chinese economy
  - Region based hierarchy: multi task nature
  - Regional competition under the control of the central government
- There are build-in mechanisms for growth, for expanding land use and urbanization
- But there is no sufficient build-in mechanism for macro control and for important aspects affecting sustainable growth
  - Admin approach for credit control in the mid 1990s
  - Central government’s failing in macro control since 2004
  - Alleged widening regional disparity (poverty trap for poor regions)
  - Environmental problems associated with abuse of land
  - Social instability caused by low compensation in land requisition (lack of legal protection of property rights)
- There is no ready theoretical solution for the multi task problem within the decentralized authoritarian hierarchy
- Regional governments have to be accountable to their constituencies rather than incentives within a hierarchy